

# CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

## BILL ANALYSIS

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<b><u>Assembly Bill 2506</u></b>	<b>Assembly Member Steinberg (As proposed to be amended)</b>
<b><u>Position:</u></b>	<b>Support, if amended (Staff recommendation)</b>
<b><u>Proponents:</u></b>	<b>TIAA-CREF (Sponsor), SSDA, 403(b)wise.com, Meridan Wealth Management</b>
<b><u>Opponents:</u></b>	<b>None known</b>

### SUMMARY

Assembly Bill 2506, as proposed to be amended, requires the California State Teachers' Retirement System (CalSTRS) to establish a registry for vendors who provide tax-deferred investment products that school districts, community college districts and county offices of education may provide to their employees.

### LEGISLATIVE HISTORY

P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), enacted a number of changes to federal law to enhance the portability of funds among different types of retirement plans, including 401(k), 403(b) and 457 plans, IRAs and 401(a) retirement plans. In addition, it increases the contribution limits to 403(b), 457 and 401(a) plans, and increases the annual allowance limit for defined benefit plans.

Chapter 291, Statutes of 1994 (AB 3064—Morrow) requires CalSTRS to offer employees of school districts, community college districts and county offices of education a 403(b) tax-deferred retirement plan.

Chapter 489, Statutes of 1994 (AB 3705—PER&SS) authorizes CalSTRS to offer its members and participants one or more 457 deferred compensation retirement plans.

Chapter 423, Statutes of 1972 (AB 1802-Knox) prohibits state agencies from negotiating life and disability insurance or annuities except to the extent that it has a direct financial interest. Also allows the employee to designate the agent, broker or company he or she purchases an annuity through and requires their employer to facilitate their designation..

### BACKGROUND

There are two provisions of the Internal Revenue Code (IRC) that provide a means for public employees to save additional funds for retirement on a tax-deferred basis. Under such an arrangement, participants do not pay income taxes on the amount contributed or the earnings of

the accounts until the funds are distributed, generally after retirement. Section 403(b) of the IRC permits employees of school districts to save funds on this basis. Historically, such funds have been saved through insurance-based products, known as tax-sheltered annuities (or TSAs), although federal legislation subsequently permitted the establishment of custodial accounts by which participants could invest in mutual funds. In addition, Section 457 of the IRC permits the establishment of deferred compensation plans for state and local public employees. Under EGGTRA, participants can contribute up to \$11,000 in 2002 in 403(b) accounts and an additional \$11,000 in a 457 account. Prior to EGGTRA, participants could not invest more than \$8,500 or \$10,500 annually, depending on the type of tax-deferred account.

The CalSTRS Voluntary Investment Program (VIP) is a 403(b) program that provides a low-cost means for public school employees to invest on a tax-deferred basis to supplement their retirement. Unlike most 403(b) plans, the CalSTRS VIP is a custodial account, which permits direct investment of contributions into mutual funds. As of February 1, 2002, there were 2,822 participants in the Voluntary Investment Program, with assets valued at over \$60 million.

VIP participants currently have the option to invest in an S & P 500 index fund, money market fund, international stock fund, and self-managed accounts, which provides over 3,000 mutual funds through a brokerage account. CalSTRS staff is initiating the process to add eight additional fund options to increase the range of asset allocation choices available as core investments to VIP participants.

Chapter 489, Statutes of 1994 authorizes CalSTRS to establish a 457 deferred compensation plan that school employers may elect to provide to their employees who are members of the Defined Benefit (DB) Program or participants in the Cash Balance (CB) Benefit Program. Although the Teachers' Retirement Board has not established a 457 plan, CalSTRS staff is investigating the advantages of implementing a program, given the substantial increase in allowable combined contributions in both types of retirement plans under EGTRRA.

Public employers tend to limit the number of administrators of 457 plans to as few as one administrator, and often make a conscious decision to select a specific entity to administer their program. In contrast, under Section 770.3 of the Insurance Code, employees may designate any licensed insurance agent, broker or company with whom to invest in a TSA. As a result, individual employers may offer hundreds of different choices to employees, and undertake little evaluation or provide little information that enables employees to make informed decisions about their supplemental retirement investments. One means by which some employers limit the number of potential vendors is a requirement they impose for the potential 403(b) vendor to enter into a hold-harmless agreement with the district. These agreements limit the liability of employer in a variety of areas, such as the failure of the employer to limit an employee's contributions in all available 403(b) options to the statutory contribution limit. In addition, the agreements often require an agent of the vendor to confirm in writing that the agent met with the participant. Because many low-cost program options, such as the VIP and other custodial accounts, do not have agents in the field, some low-cost options are not available in districts that impose such requirements.

## DISCUSSION

AB 2506, as proposed to be amended:

- Requires the Board to establish by July 1, 2003, a registration process for vendors that wish to offer 403(b) and 457 retirement plan investment products to employees of school districts, community college districts and county offices of education.
- Requires the Board to register those products that provide information regarding :
  1. Investment products and distribution options
  2. Administrative, plan and reporting features
  3. Administrative costs, fees, and penalties
  4. Retirement counseling and education services
  5. Office locations and counseling service areas
  6. History and record of experience
  7. Financial ratings by recognized commercial rating agencies
  8. Certain NASD and SEC filingsThe Board may impose additional information requirements.
- Requires the Board to establish an annual open registration period and allows the Board to require vendors to renew their registration at least every five years.
- Requires the Board to establish and maintain a data bank of registered vendors and their retirement investment products for employers and participants that contains "objective" comparisons of participant cost and education, vendor experience and services.
- Authorizes the Board to assess vendors for the costs it incurs in maintaining the registration process and data bank. (The bill does not specifically allow the cost of establishing the registration process to be paid by vendor fees.)
- Requires school employers to offer their employees by July 1, 2004, an "open enrollment" period in which the employees choose tax-deferred investment alternatives from the list of registered vendors.
- Authorizes school employers to allow current employees to keep their existing accounts with companies that do not become registered.
- Authorizes school employers to assess vendors for the costs they incur in selecting vendors and associated administrative costs, but prohibits the employer from receiving any other direct or indirect consideration or compensation.

According to the sponsor, TIAA-CREF: "teachers and other school district employees that qualify to purchase tax-sheltered annuities (TSAs) through their 403(b) plans are drowning in choice. California Insurance Code 770.3 allows these employees to purchase TSAs through any

provider or company of their choice. But what began as a law intended to protect employees' freedom of choice has resulted in an unwieldy benefits system with excessive providers, administrative burdens, and ongoing liability concerns. Many teachers struggle to budget for their retirement, only to discover that undisclosed fees, penalties, and restrictions erode their savings. Companies in the private sector screen retirement products for their employees' 401(k) plans. Teachers demand a similar screening performed for 403(b) products.”

Under AB 2506, as proposed to be amended, companies that offer Section 403(b) annuity plans directly to employees of school districts, community college districts and county offices of education must, for the first time, register their products with CalSTRS and enter into agreements with individual school employers before credentialed and classified school employees may select their products. Providers of Section 403(b) custodial account plans and Section 457 deferred compensation plans must also register their products with CalSTRS to be considered by school employers. There are an estimated 1,000 403(b) plans and 300 457 plans currently on the market. The bill does not propose any changes in state law that would address issues raised by the types of harm harmless agreements required by some districts.

Under the bill, CalSTRS staff would evaluate the information AB 2506 requires vendors to supply and identify any additional information that may be necessary to implement its intent. CalSTRS would also develop internal documents, external publications and forms detailing the specifications for the information vendors must provide about their plans, including a description of acceptable formats (preferably electronic to ease processing and publishing), and methods of delivery. CalSTRS would also develop a process to verify that the information vendors provide is complete and undertake follow-up activities with vendors whose submittals did not meet the requirements.

AB 2506 establishes a registration, not a regulatory process within CalSTRS. Rather than evaluating the financial strength of individual vendors or the value of their investment options, AB 2506 requires CalSTRS to be only a complier of and repository for specified information on 403(b) and 457 retirement plan products. The bill does not require CalSTRS to evaluate the viability of the investment products, or even the accuracy of the information provided by the vendors. Nonetheless, because the vendor was registered with CalSTRS, CalSTRS may be held responsible, at least in the minds of participants, if there was inappropriate activity or a business failure by a registered vendor, and participants suffered economic losses. The bill could be amended to legally absolve CalSTRS of any liability for the actions of the registered vendors, but that would not necessarily change how affected participants viewed CalSTRS' responsibility in the matter. In addition, even though the information that would be included in the registry would be provided by the individual applicant, some may question the accuracy of information being provided about different vendors when it is provided through a CalSTRS-produced registry, given that CalSTRS is itself a provider of 403(b) investment options that provide an alternative to other products. If CalSTRS was expected to evaluate the individual registrant, concerns about the appropriateness of CalSTRS having that responsibility would likely be even more significant.

Establishing the registration process would require CalSTRS to, among other things, (1) develop a database to store the collected information, (2) identify the specific information that is required to meet the requirements the bill imposes on applicants in order to register with CalSTRS, (3) develop a standardized form that would permit potential registrants to submit the required information both on paper and electronically and (4) inform both employers and the investment community of the requirements imposed by the bill. CalSTRS would also have to produce a publication that includes all the required information, and establish a website that enables school employees to obtain the requested information online. Given the multitude of tasks inherent in establishing a new program, hiring personnel to administer it, informing interested parties and registering vendors for the first time, and making the information available for dissemination, staff does not believe it can complete the registration process by July 1, 2003 and recommends a completion date of January 1, 2004.

## **FISCAL IMPACT**

### Benefit Program Costs – None

Administrative Costs – Staff estimates total one-time costs of \$500,000 to develop the registration process, process initial enrollment by vendors and establish the database. There would be ongoing personnel and operating costs of \$75,000 annually to maintain the database information. If CalSTRS was expected to evaluate the quality of (1) the information provided at registration, (2) the applicants or (3) the investment options, initial and ongoing costs would be higher.

Any ongoing costs would be paid from fees imposed on registrants. If amended, the costs to establish the registration process also would be paid from registration fees.

## **RECOMMENDATION**

Support, if amended to extend the required implementation date and absolve CalSTRS of any liability for vendor actions. This bill will require extensive administrative activities to complete implementation, including establishing a website for vendor registration, informing interested parties about the registration process and disseminating information to vendors. Therefore, the bill should be amended to delay completion for the registration process until January 1, 2004. Further, because CalSTRS would not be making any representation with respect to the applicants or other products, this bill should be amended to absolve CalSTRS of any liability for the actions of the registered vendors.